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IN THE

Supreme Court of the United States

October Term, 1946

No. 92

WALTER P. GARDNER, Trustee of THE CENTRAL RAILROAD COMPANY OF NEW JERSEY,
Petitioner,

vs.

THE STATE OF NEW JERSEY.

BRIEF ON BEHALF OF PETITIONER IN REPLY TO BRIEF ON BEHALF OF THE STATE OF NEW JERSEY and BRIEF ON BEHALF OF THE CITY OF JERSEY CITY, *Amicus Curiae*

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The Attorney General of New Jersey in his brief for the State urges certain concepts that are contrary to settled bankruptcy law. The only concession he makes is that the Bankruptcy Court on the filing of a petition for reorganization by a railroad has authority to enjoin the State from the enforcement of its liens for taxes until the reorganization of the road is effected (State's brief, p. 39). He then urges that the trustee upon his appointment in a reorganization proceeding takes possession only of those

assets of the debtor which are in excess of an amount sufficient to pay the lien of the State in full, with interest at 1% per month (pp. 99, 112).

The Attorney General apparently considers that the State's lien is like a wall that surrounds and encloses a part of the railroad property, the portion within the wall being set apart for the State and that outside the wall being left to the trustee for reorganization purposes. This concept is not supported by the State law (Rev. 54:27-4), nor by any decision in any court of which we have knowledge. Whether this wall encloses the carrier's terminal properties or one or more of its main line tracks is not stated. The adoption of this view of the Attorney General would absolutely prevent the reorganization of a railroad under Section 77.

The next concept urged by the Attorney General is that the Bankruptcy Court is without jurisdiction in any way to question, examine or pass upon the lien given by a State statute (pp. 99-107). He contends that the Bankruptcy Court must either order the amount claimed by the State to be paid in full and in cash, or proceed with the reorganization as to all other parties and claimants and then turn the properties over to the reorganized debtor subject to the State's lien, to the end that the State, being freed of the court's injunction, may enforce its lien against the reorganized debtor in any way that the State statutes permit. This concept would defeat the entire purposes of Section 77 of the Bankruptcy Act, whose protection from such actions by the State was sought by the debtor in this case when it filed its petition for reorganization.

Although the Bankruptcy Act (Sections 57, 64, and 77(c)(7)) provides that a State must file in the proceedings its verified claim and claim a lien if one is asserted, the Attorney General solemnly urges that such a claim, when filed by a duly authorized State officer, is not like the

proof of claim filed by any other creditor, but has no more force or effect than a notice to the trustee and the court and others interested that the State has a lien on the properties of the debtor in the amount stated in the claim (pp. 113 and 115). This, also, is a concept that is new, which has no authority to support it, and, if adopted, would defeat the jurisdiction of the Bankruptcy Court to reorganize a railroad under the provisions of Section 77.

Finally, the learned Attorney General contends that a State which has filed a claim in the proceedings asserting both a lien on all the assets of the debtor and priority over all other creditors in payment, has the right voluntarily to enter the proceedings as a party, and demand and receive large payments on account, out of the general funds of the debtor, without submitting its claim or lien in any respect to the jurisdiction of the Bankruptcy Court, on the ground that the State is a sovereign power which cannot be sued without its consent (pp. 39-40). He glosses over the effect of his many general appearances in the cause and his demand and receipt of very large payments on account of the State's claim, in effect asserting that since "The power to tax is the power to destroy" (*McCullough* v. *Maryland*, 4 Wheat. 316, 427, 429), the Bankruptcy Court must leave the State free to do its will after the reorganization is completed. The adoption of any such concept would utterly prevent the successful reorganization of the debtor.

Conceding *arguendo* that there are important questions for decision raised by the trustees' petition of August 14, 1944, both the State and the City of Jersey City contend that all questions raised thereby should, on the grounds of comity, be referred to the courts of the State for decision, and that the Bankruptcy Court should defer further proceedings before it while awaiting the decision of the State courts on these most important questions.

The answer to this contention is that the decision of the questions raised by the trustees' Petition for Adjudi-

cation of the State tax claim is within the exclusive jurisdiction of the Bankruptcy Court. *Isaacs, Trustee* v. *Hobbs Tie & Timber Co.*, 282 U. S. 734; *Straton* v. *New*, 283 U. S. 318. (See our principal brief, pp. 45 and 52.)

Manifestly, only the Bankruptcy Court has jurisdiction to determine the prime question presented in this case, namely: Whether the claim of the State was compromised under the provisions of Section 27 of the Bankruptcy Act and has been fully paid by the trustee under the instructions and on the orders of the Bankruptcy Court or, if not, in view of equities that have intervened, what further amount, if any, is now due to the State and the terms on which it should be discharged?

I

The State's argument rests on a false premise of fact.

The several contentions of the Attorney General referred to above are based on the erroneous assumption that the amount of the debtor's tax liability for the years 1932 to 1940, inclusive, has been finally adjudicated and that the State has a lien for the full amount of taxes and interest claimed.*

This fallacy also underlies the decisions of the Court of Appeals in *Wilentz* v. *Hendrickson*, 135 N. J. Eq. 244, and of the court below, 152 Fed. (2d) 408.

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*The extent of the State's alleged tax lien is thus defined in the State's brief (p. 83):

> "In the present case, of course, the tax debt to the State of New Jersey, both for principal and interest, is secured by a statutory lien on all of the lands, tangible property and franchises of the debtor situated in this State. R.S. 54:27-4; R.S. 54:27-6; Wilentz v. Hendrickson, *supra*, where it was stated (133 N. J. Eq., at p. 466):
>
> "'The reference to the obligation for which a lien is given embraces the accrued interest.'"

As we have shown in the Statement of Facts in our principal brief (pp. 5-8, incl.), only the litigation in the State and Federal Courts concerning taxes for the years 1932 and 1933 had been concluded prior to the filing of debtor's petition for reorganization.

The State's taxes for 1934, 1935 and 1936 were under contest when the petition for reorganization was filed, and the judgment of the United States District Court reducing the amount of taxes for said years was not reversed by the Circuit Court of Appeals until November 27, 1940 (see State's Proof of Claim, R. 70, 71).

The State's claim for taxes for the years 1937, 1938 and 1939 were duly appealed to the State Board of Tax Appeals and such appeals had not been determined by that body at the time of the filing of the State's proof of claim on or about December 10, 1940 (R. 71). In accepting the provisions of the Settlement Acts the trustees waived their right to a judicial review of such taxes after they were affirmed by the State Board. As to the taxes for 1940 and 1941, even an administrative review was waived. Moreover, there has been no judicial review of the State's enormous claim for interest. The State's claim represents merely the debtor's maximum liability.

The one and only thing that settled and fixed the principal amount of the taxes and interest payable to the State was the undertaking filed with the State Treasurer by the trustees under Chapter 290, P. L. 1941, as amended by Chapter 241, P. L. 1942, in which undertaking, with court approval contained in Orders Nos. 123, 135 and 163, the trustees agreed to pay the principal amount of delinquent taxes levied for the years 1932 through 1940, in annual instalments over a period of twenty years, together with interest at 3% per annum from December 1, 1940.

II

The State's argument also rests on a false premise of law, that is, that the estate *in custodia legis* is only the equity above the liens.

The contentions of the Attorney General wholly disregard what this Court said in *Straton* v. *New*, 283 U. S. 318, p. 321, regarding the jurisdiction of the Bankruptcy Court:

> "This jurisdiction is exclusive within the field defined by the law, and is so far in rem that the estate is regarded as *in custodia legis* from the filing of the petition."

The proceeding is in rem as to every piece of property, owned and possessed by the debtor as of the date of the filing of the petition. *Isaacs, Trustee* v. *Hobbs Tie & Timber Co., supra.* In view of the law as settled by this court on the authorities stated in our principal brief, the contention of the State that its lien can in no respect be questioned, examined or determined in nature, amount or extent, is wholly without merit.

The Attorney General, however, contends that the only property in the hands of the trustee is the equity beyond the State's lien. He does not indicate how the amount of that equity can be determined other than by the Bankruptcy Court. If he is correct in his contention that the Bankruptcy Court lacks power to pass upon the amount and validity of the State's lien, then it necessarily follows that the court can never evaluate the equity which he asserts is the only asset the trustee is possessed of and of which the court has jurisdiction.

At this point we think the court's attention should be called to Section 77(e) of the Bankruptcy Act, which provides that the valuation "of any property for any purpose under this section shall be made by the Interstate Commerce Commission" with due regard to the earning power of the property.

III

The question of what interest, in view of all the equities, should be allowed on the State's claim may be of paramount importance in this proceeding.

We have shown that if it be determined that a compromise was effected between the State and the debtor's trustee under the terms of the Railroad Tax Settlement Acts, the State is entitled only to the principal of the taxes for 1932 to 1940, inclusive, together with 3% interest thereon from December 1, 1940. In the event, however, that it should be determined that there was no such compromise, then a highly important question will arise as to whether any interest should be allowed the State on its tax claims from and after the date of the filing of the petition for reorganization in view of the decision of this Court in *Vanston Bondholders Protective Committee* v. *Green, et al.*, filed December 9, 1946 (Nos. 42-45, Oct. Term, 1946).* The opinion of Mr. Justice Black contains these statements:

> "A purpose of bankruptcy is so to administer an estate as to bring about a ratable distribution of assets among the bankrupt's creditors."

Again:

> "But bankruptcy Courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles. And we think an allowance of interest on interest under the circumstances shown

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* Another highly important question arises as to the applicability of the following equitable principle: A court of equity has jurisdiction to enforce a compromise from which the offeror seeks to withdraw where the offeree has acted thereon to his prejudice.

Trenton Street Railway Co. v. *Lawlor* (E. and Ap.), 74 N. J. Eq. 828.

by this case would not be in accord with the equitable principles governing bankruptcy distributions.

When and under what circumstances Federal Courts will allow interest on claims against debtors' estates being administered by them has long been decided by federal law (citing cases)."

We have shown in our main brief how the State has thwarted an adjudication as to the amount of its claim by the litigation and appeals which its Attorneys General have prosecuted.

The State contends that the penalty interest continues to run at 1% per month until both the principal and interest are paid in full under the formula laid down by Justice Oliphant in *State* v. *Erie Railroad Co., et al.*, 23 N. J. Misc. 203.* These interest penalties are so large as far to exceed the principal amount of the taxes, to the great detriment of the bondholders who are secured by a mortgage on the debtor's entire assets. Suppose these interest penalties had been 2% or 3% per month instead of 1% per month, and suppose the State Courts had determined that they were not penalties but interest? Would the Bankruptcy Court be obliged to hold them to be interest rather than penalties, even though they would consume the entire estate of the railroad? It is not to be overlooked that when the petition for reorganization was filed the total liquid resources of the railroad were $7,097,458 against the principal of taxes claimed by the State aggregating $15,067,002 (R. 199, 200) exclusive of interest penalties.

It is respectfully submitted that under the decision in the *Vanston* case, *supra*, the Bankruptcy Court alone has the jurisdiction, acting on equitable principles and paying due regard to the interests of all persons interested in the debtor's estate, to determine whether it would be equitable to allow the State to recover its penalties in full.

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* Legal interest in New Jersey is 6% per annum. R. S. 31:1-1.

IV

The Trustees' petition of August 14, 1944, for adjudication concerning the State tax claims was not a suit against the State because (A) this is a proceeding *in rem* in which the State has appeared as claimant; and (B) the only determination requested is an adjudication as to the amount, if any, payable to the State on its claim and the nature and extent of its lien.

(A) The State appeared as a claimant.

It is well settled that when the State's claim was formally filed in the Bankruptcy Court its alleged lien became merely incidental thereto. *Coder* v. *Arts*, 213 U. S. 223; *In re Florence Com. Co.*, 19 Fed. (2d) 468.

The contention of the Attorney General that the proof of claim filed by the State was a mere notice is answered by the decision of this court in *New York* v. *Irving Trust Co.*, 288 U. S. 329, p. 333, where it was said:

> "If a State desires to participate in the assets of a bankrupt, she must submit to appropriate requirements by the controlling power; otherwise, orderly and expeditious proceedings would be impossible and a fundamental purpose of the Bankruptcy Act would be frustrated."

When the State appeared in the debtor's proceedings both before and after filing its proof of claim and demanded payments on account, it made an election, if ever a State can make an election, to appear voluntarily and seek liquidation of its claim. When it filed its claim in the proceedings it, of course, submitted that claim to the jurisdiction of the Bankruptcy Court. In addition, when the State passed its Settlement Acts, Chapter 290, P. L. 1941, and Chapter 241, P. L. 1942, it in terms authorized

and directed the Attorney General "to execute in the name of the State of New Jersey any and all consents to a plan or plans of reorganization of a railroad corporation under the Federal Bankruptcy or other laws, to the extent that such plan provides for payment to the State on claims for taxes in accordance with the provisions of the Act" (Sec. 9).

(B) The only affirmative action sought is an adjudication of the amount, if any, still payable to the State on its claim and the extent of its lien.

No right is asserted by the trustee against the State which extends beyond the claim that the State has filed. The trustee merely wants the Bankruptcy Court to determine, as it must determine before there can be a reorganization of the debtor: (1) How much is due the State, if anything, for principal of its taxes; (2) How much is due the State for interest on its claims, if anything; (3) What lien, if any, does the State now have; and (4) As between the bondholders and the State, who has priority?

The petition for a decision on these questions is simply in the nature of a motion in a pending proceeding and does not constitute a suit against the State without its consent.

Cohen v. *Virginia*, 6 Wheat. 264;
Wiswall v. *Campbell*, 93 U. S. 347;
Hanover National Bank v. *Moyses*, 186 U. S. 181;
Meek v. *Centre County Banking Co.*, 268 U. S. 426;
In re Williams Oil Corp., 265 Fed. 401;
U. S. v. *Moscow Seed Co.*, 14 Fed. Supp. 135.

Finally, the Attorney General, overlooking the decision to the contrary in *Hanover National Bank* v. *Moyses* (*supra*), seems to think that the only way a State can be

made a party to such a reorganization proceeding is by the issuance of process of some kind against the State.

It is elemental that a State, like any other person, firm or corporation, may enter a judicial proceeding by voluntarily appearing and petitioning for some right or benefit in its own favor, e. g., by asking for immediate cash payments on a claim that might otherwise be deferred, and by filing a claim for relief.

V

Such questions as remain open are exclusively for the Bankruptcy Court.

The assertion by both Jersey City and the State that questions concerning the State's claim and lien should be referred to the State courts on the grounds of comity and on the authority of *Spector Motor Service, Inc.* v. *McLaughlin*, 323 U. S. 101, is one that invites further delay in reorganization proceedings that should long ago have been concluded, and invites the Bankruptcy Court to yield its exclusive jurisdiction to the State in matters that the Bankruptcy Court alone is competent to deal with promptly and efficiently. Unlike the situation in the *Spector* case, the New Jersey law has already been settled. Under the New Jersey law, as we have shown in our principal brief, there was a valid compromise. See also *Trenton Street Railway Co.* v. *Lawlor* (E. & Ap.), 74 N. J. Eq. 828.

Moreover, the settlement was valid under Section 27 of the Bankruptcy Act, as we have heretofore shown, and that question is not even discussed in the State's brief. The State does, however, contend on the authority of *Hyman* v. *Long Branch Kennel Club*, 115 N. J. L. 123, that in New Jersey "An act which violates the Constitution with respect to subject matter is void ab initio" (Brief, p. 127).

While the *Long Branch* case disapproved a dictum in *Lang* v. *Bayonne*, 74 N. J. L. 455, it did not in any sense purport to set aside the New Jersey rule on which we rely in our principal brief (pp. 75-77), i. e., that the holding that a statute is unconstitutional does not mean that it may be treated as a nullity if action was taken under it prior to a decision that it is unconstitutional, or the other New Jersey doctrine on which we rely, that a decision that an Act of the Legislature is unconstitutional, based upon a stipulation as to the facts, operates only in personam on the parties to the action who made the stipulation, and not in rem.

We have heretofore referred to the fact that the obstructive tactics of the Attorney General's office have prevented the speedy reorganization of the debtor which Section 77 contemplates. We find in the State's brief (p. 51) this statement:

> "Just how much power did Congress intend to give the Bankruptcy Court with respect to a State's liens for taxes affixed at the time of the institution of Section 77 proceedings?
>
> "Unless this vital question can be answered at this time, the State of New Jersey already considerably harassed with seemingly endless litigation with respect to these taxes, may be compelled twice more to come before this Court—first, in opposition to a claimed power to include the New Jersey taxes in a reorganization scheme otherwise than on the basis of cash payment; and, secondly, in opposition to a claimed power in the Bankruptcy Court to compel the State to participate in a plan providing for other than cash payment upon the State's refusing to participate voluntarily in such plan."

A somewhat similar suggestion of interminable further litigation appears in Jersey City's brief, pages 43, 44.

Accompanying this threat of further litigation is the insistment of the State, on page 128, that in view of the decision in the *Spector* case (*supra*) the Bankruptcy Court should refer the questions presented in the trustees' petition of August 14, 1944 to the State courts,—a proceeding which would still further unnecessarily prolong the debtor's reorganization, because, as this Court pointed out in *Public Utilities Comm.* v. *United Fuel & Gas Co.*, 317 U. S. 456, p. 463:

> "But where, as here, no state court ruling on local law could settle the federal questions that necessarily remain, and where, as here, the litigation has already been in the federal courts an inordinately long time, considerations of equity require that the litigation be brought to an end as quickly as possible."

It is respectfully submitted that on the record now before the court, this Court may, if it deem proper, issue such instructions to the courts below as will be dispositive of the very important questions that are presented in this case.

For the State seriously to urge that the State Treasurer is enjoined by the decree in *Wilentz* v. *Hendrickson* from accepting payment of the amount of its claims in accordance with the terms of the Tax Settlement Acts seems idle, because if the compromise is valid at law or available as an equitable defense (see *Trenton St. Ry. Co.* v. *Lawlor*, 74 N. J. Eq. 828), the State already has received full payment (see Order No. 333, R. 296; receipt for $15,250,000, R. 318).

If it should, on the other hand, be determined that there was no compromise, and that no equities in favor of debtor have intervened, so that the State is entitled to collect the full amount of its taxes assessed plus penalties of

1% per *month* from the date in each year when the taxes were payable to the date of payment in full, an amount aggregating some additional $15,000,000, then, of course, the reorganization court and the Interstate Commerce Commission will have to provide in a plan how such claim can be liquidated.

December 16, 1946.

Respectfully submitted,

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